42 Claiming Depreciation Deductions

There are two methods of claiming expense deductions for your purchases of equipment, fixtures, autos, and trucks used in your business:

- First-year expensing (Section 179 deduction), which allows a deduction of up to $17,500. In 1997, the deduction limit will be $18,000.
- Regular depreciation, which allows a prorated deduction over a period of years. Most business equipment is depreciable under MACRS over a six-year period. The objective of MACRS is to provide rapid depreciation and to eliminate disputes over useful life, salvage value, and depreciation methods. Useful life and depreciation methods are fixed by law; salvage value is treated as zero. If you do not want to use MACRS accelerated rates, you may elect the straight-line method. MACRS applies to new and used property.

Capital investments in buildings are depreciable using the straight-line method; residential buildings are depreciated over 27.5 years; nonresidential real property placed in service after May 12, 1993, is depreciated over 39 years; *see* ¶42.13. Specific annual rates for each class of property are provided by IRS tables.

¶42.1 What Property May Be Depreciated

Depreciation deductions may be claimed only for property used in your business or other income-producing activity.

Depreciation may not be claimed on property held for personal purposes such as a personal residence or pleasure car. If property, such as a car, is used both for business and pleasure, only the business portion may be depreciated.

Property bought for income-producing purposes, although yielding no current income, may be depreciated.

EXAMPLES

1. An anesthesiologist suspended his practice indefinitely because of malpractice premium rate increases. He continued to maintain his professional competence by taking courses and keeping up his equipment. The IRS ruled that he could not take depreciation on his equipment. Since he was no longer practicing, the depreciation did not relate to a current trade or business.
2. An electrician spent $1,325 on a trailer to carry his tools and protective clothing. Based on a useful life of three years less salvage value of $25, annual depreciation deductions came to $433. However, the IRS claimed that he could not claim depreciation during the months he was unemployed and the trailer was not used. The Tax Court disagrees. Depreciation is allowed as long as the asset is held for use in a trade or business, even though the asset is idle or its use is temporarily suspended due to business conditions.

Nondepreciable assets. Not all assets used in your business or for the production of income may be depreciable. Land is not depreciable, but the cost of landscaping business property may be depreciated if the landscaping is so closely associated with a building that the landscaping would have to be destroyed if the building were replaced. Qualifying trees and bushes are depreciable over 15 years.

Property held primarily for sale to customers or property includible in inventory is not depreciable, regardless of its useful life.

Amortization for business intangibles. The cost of goodwill, going concern value, and other intangibles including covenants not to compete, information bases, customer lists, franchises, licenses, and trademarks is amortizable over a 15-year period.

The amortization election generally applies to property acquired after August 10, 1993. *See* ¶42.18 for further details.

Residences. For depreciation of rented residences, *see* ¶9.5.

For depreciation of a sublet cooperative apartment or one used in business, *see* ¶40.16.

Farm property. Farmland is not depreciable; farm machinery and buildings are. Livestock acquired for work, breeding, or dairy purposes and not included in inventory may also be depreciated. For a detailed explanation of the highly technical rules for depreciating farm property and livestock, *see* IRS Publication 225, Farmer's Tax Guide.

Prior-year returns. Incorrect deductions claimed in prior years may not be corrected by an adjustment to your present depreciation deduction. If the year in which the error was made is not yet closed by the statute of limitations, you may file an amended return to adjust the depreciation deduction for that year. If the year is closed, you may make an accounting method adjustment. *See also* ¶5.24 for adjustments of incorrect depreciation taken in prior years.

Dispute over importance of useful life. Before 1981, useful life was basic to determining depreciation, and there were two applications of useful life: (1) whether an asset had a determinable life—if the asset, such as land, had an indefinite or indeterminable useful life, depreciation was not allowable—and (2) if it had a useful life, what the period of useful life was. This two-part approach of useful life has become blurred in recent cases involving depreciation of antique musical instruments and exotic display automobiles. No one disputes that Congress in passing ACRS and MACRS intended to do away with factual disputes in determining the useful life of a depreciable asset. But the IRS has argued that Congress did not intend to do away with the basic issue posed by (1), whether an asset with an indeterminable life is entitled to depreciation at all. The IRS has failed to convince the Tax Court of its position. According to the Tax Court, under ACRS (1981–86) and current MACRS law, useful life is irrelevant for claiming depreciation if you can show that an asset is subject to exhaustion, wear and tear, or obsolescence. Thus, in the case of antique musical instruments played by professional musicians, depreciation is allowable because of wear and tear, even though the instruments have an indeterminable useful life. Two federal appeals courts have agreed, allowing professional violinists to deduct ACRS depreciation for their instruments.

In a case involving exotic cars that were not used for transportation but for exhibition, MACRS depreciation was allowed because the owner showed that they were subject to obsolescence. The autos were purchased solely for exhibition. The three state-of-the-art autos were a 1987 Lotus Pantera costing $63,000, a Lotus Espirit costing $48,000, and a Ferrari Testarossa costing $290,453. Over a four-year period, the owner deducted depreciation of over $298,000 while reporting gross income from exhibition fees of $96,630. The IRS disallowed the depreciation because the cars had no determinable useful life. The Tax Court allowed the depreciation because such cars are subject to obsolescence in the car-show business when new models appear with newer designs and high-tech features. One witness testified this could occur in some cases within a year.

The Tax Court warned that such exotic cars should not be confused with museum pieces. If they had been museum pieces, such as antique cars, no depreciation would have been allowed because in the case of art objects and antiques used as business assets, the finding of useful life remains relevant because such assets are not subject to exhaustion, wear or tear, or obsolescence.

The IRS has announced that it will continue to dispute and litigate cases in which depreciation is claimed on assets with indeterminable useful lives.

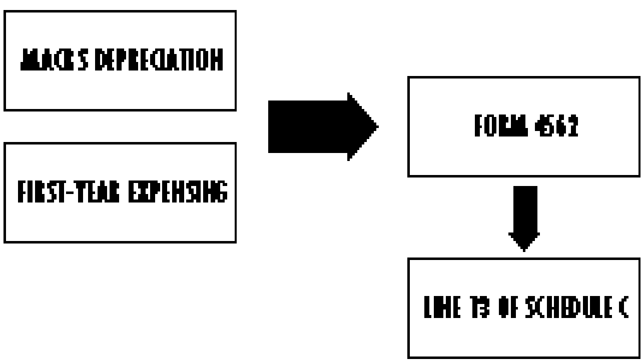
¶42.2 Claiming Depreciation on Your Tax Return

If you report business or professional self-employed income, use Form 4562 for assets placed in service during 1996 and enter the total deduction on Line 13, Schedule C. For claiming depreciation on "listed property" such as cars, computers, and cellular phones, you use Form 4562, regardless of the year placed in service. Listed property is explained at ¶42.10. If your only depreciation deduction is for pre-1996 assets, none of which is listed property, you do not need to use Form 4562; figure the deduction on your own worksheet, and enter it on Line 13, Schedule C.

If you are an employee claiming auto expenses, you must use Form 2106 to claim depreciation on an automobile used for business purposes.

If you report rental income on Schedule E, you must use Form 4562 for buildings placed in service in 1996. For buildings placed in service before 1996, enter the depreciation deduction directly on Schedule E. If you have a rental loss on Schedule E, your deduction for depreciation and other expenses may have to be included on Form 8582 to figure net passive activity income or loss; *see* Chapter 10.

See the sample Schedule E in Part VIII of this book.



¶42.3 First-Year Expensing Deduction

For qualifying business equipment purchased and placed in service in 1996, you may elect to deduct up to $17,500 of the cost. For equipment placed in service by a business in an "enterprise zone," the deduction may be as high as $37,500. For an automobile, the maximum expensing deduction in 1996 is $3,060; *see* ¶43.4. The portion of cost not eligible for first-year expensing may be recovered by depreciation under the regular MACRS rules. The first-year expensing deduction is technically called the "Section 179 deduction."

In 1997, the first-year expensing cap is $18,000.

You may *not* elect first-year expensing for property purchased before 1996, even if 1996 is the first year you use it for business.

The election is limited to tangible personal property bought in 1996 for business use, such as machinery, office equipment, a computer, car, or truck acquired from non-related parties. The deduction is not allowed for buildings, structural components of buildings, furniture or refrigerators used in operating apartment buildings, property held for the production of income, or equipment previously used for personal purposes, such as an automobile bought for pleasure but later used for business.

To claim the first-year expensing deduction on Form 4562, which you attach to your Form 1040, you must make the election on an *original* return for the year the property is placed in service (whether or not the return is timely filed). First-year expensing may *not* be claimed on an amended return unless it is filed within the due date for the original return (including extensions). If you fail to make the election on an original return (or on an amended return filed by the due date including extensions) the election is lost. You may not revoke the expensing election without consent from the IRS.

CAUTION — Losses and Low Income May Limit Deduction

The expensing deduction may not exceed the net taxable income from all businesses which you actively conduct. Net income from active businesses is figured without regard to expensing, the deduction for 50% of self-employment liability, or any net operating loss carryback or carryforward. You may include wage or salary income as active business income and if you are married filing jointly, also include your spouse's net taxable income.

If you have an overall net loss from all actively conducted businesses, you may not claim a 1996 expensing deduction. If net income is less than the cost of qualifying assets, expensing is limited to the income. However, the cost over the income limit is carried forward to 1997 on Form 4562 provided you complete the expensing section of Form 4562 for 1996. You do *not* get a carryover unless the deduction is claimed on the return for the first year the property is placed in service.

Partial business use. If you use the equipment for both business and personal use, business use must exceed 50% in the year the equipment is first placed into service to claim a first-year expensing deduction. The expensing deduction may be claimed for the cost allocated to business use up to the $17,500 limit; the 1996 limit for a car is $3,060 (¶43.4).

To elect first-year expensing for "listed property" such as a computer or car (¶42.10), business use in the first year you use it must exceed 50%. If it does, you show the amount eligible for expensing in the section for "Listed Property" on Form 4562 and then transfer the amount to the part of Form 4562 where the expensing election is claimed.

Figuring the deduction. The maximum annual deduction in 1996 is $17,500 of the cost of qualifying property and $3,060 for a car (¶43.4). For business use of less than 100% (but more than 50%), the expensing deduction is limited to the business portion of the cost. As discussed below, the $17,500 limit may have to be reduced because your taxable income is lower than $17,500, eligible purchases exceed $200,000, or you are married filing separately.

If you qualify for the full $17,500 limit, you do not have to claim the entire amount. If in 1996 you place in service more than one item of property, you may allocate the $17,500 deduction between the items. If you placed in service only one item of qualifying property which cost less than $17,500, your deduction is limited to that cost.

If you acquire property in a trade-in, the cost eligible for expensing is limited to the cash you paid. You may not include the adjusted basis of the property traded in, although your basis for the new property includes that amount.

Year-End Purchases

Equipment placed in service on the last day of the taxable year may qualify for the entire $17,500 first-year expensing deduction. You do not have to prorate the $17,500 limit for the amount of time you held the property.

Effect on regular depreciation. If the cost basis of the property exceeds the first-year expensing limit, you compute depreciation on the cost of the property less the amount of the first-year deduction.

EXAMPLE

In 1996, you placed in service a $30,000 machine and a $1,500 lathe. You elect to deduct as a first-year expense $1,500 for the lathe and $16,000 for the machine, a total of $17,500, the maximum first-year deduction. The $1,500 deduction has completely recovered the cost of the lathe. The cost of the machine is reduced by $16,000, giving a depreciable basis of $14,000 ($30,000 – 16,000).

$17,500 limit reduced if taxable income is lower. Your expensing deduction may not exceed net income from all your active businesses; *see* the Caution Alert in the preceding column.

$17,500 limit reduced if qualifying purchases exceed $200,000. If the total cost of qualifying property placed in service during a taxable year is over $200,000, the $17,500 expensing limit is reduced dollar for dollar by the cost of qualifying property exceeding $200,000. For example, if you place in service machinery costing $206,000, the $17,500 limit is reduced by $6,000. The reduced limit of $11,500 is shown on Form 4562 on the line labeled "Dollar limitation for tax year." If the total cost is $217,500 or more, no first-year expensing deduction is allowed.

$17,500 limit reduced if married filing separately. If you and your spouse file separate returns, the expensing limit for both of you is $17,500. Unless you agree to a different allocation, you are each allowed only a $8,750 expensing limit. The $200,000 cost threshold also applies to both of you as a unit. For example, if you place in service qualifying property costing $195,000 and your spouse places $9,000 of property in service, the total cost of $204,000 reduces the $17,500 limit by $4,000 to $13,500. The reduced limit for each of you on separate returns is $6,750.

Partners and S corporation stockholders. For property bought by a partnership or an S corporation, the $17,500 limit and taxable income limit applies to the business, as well as the owners as individual taxpayers. The partnership or S corporation determines its expensing deduction subject to the limits and allocates the deduction, if any, among the partners or shareholders. The allocated deduction may not exceed the net taxable income of the partnership or S corporation from actively conducted businesses.

An individual partner's expensing deduction may not exceed $17,500, regardless of how many partnership interests he or she has. However, the partner must reduce the basis of each partnership interest by the full allocable share of each partnership's expensing deduction, even if that amount is not deductible because of the $17,500 limit.

Disqualified acquisitions from related parties. Property does not qualify for the expense election if:

1. It is acquired from a spouse, ancestor or lineal descendant, or from non-family-related parties subject to the loss disallowance rule of ¶33.10. For purposes of the expensing election, a corporation is controlled by you and thus subject to the loss disallowance rule of ¶33.10 if 50% or more of the stock is owned by you, your spouse, your ancestors, or your descendants.
2. The property is acquired by a member of the same controlled group (using a 50% control test).
3. The basis of the property is determined in whole or in part (a) by reference to the adjusted basis of the property of the person from whom you acquired it or (b) under the stepped-up basis rules for inherited property.

Recapture of expensing deduction. Recapture of the first-year expensing deduction may occur on a disposition of the asset or if business use falls to 50% or less. If the business use falls to 50% or less after the year the property is placed in service but before the end of the depreciable recovery period (¶42.4, ¶42.10) you must "recapture" the benefit from the first-year expensing deduction. The amount recaptured is the excess of the expensing deduction over the amount of depreciation that would have been claimed (through the year of recapture) without expensing; *see* ¶42.10. Recaptured amounts are reported as ordinary income on Form 4797.

When you sell or dispose of the property, the first-year expensing deduction is treated as depreciation for purposes of the recapture rules (¶44.1) that treat gain realized as ordinary income to the extent of depreciation claimed.

Expensing Limit Increases After 1996

In 1997, the deduction limit will increase to $18,000; in 1998, to $18,500; in 1999, to $19,000; in 2000 to $20,000; in 2001 and 2002 to $24,000; and after 2002 to $25,000.

¶42.4 MACRS Class Lives

Depreciable assets other than buildings fall within a three-, five-, seven-, 10-, 15-, or 20-year class life. For property in the three-, five-, seven-, and 10-year classes, the depreciation method is 200% declining balance, with a switch to straight line. Instead of the 200% rate, you may elect a 150% rate; *see* ¶42.8. For 15- and 20-year property, the 150% declining balance method is used with a switch to straight line. The conversion to straight line is made when larger annual deductions may be claimed over the remaining life.

Straight-line recovery for buildings is discussed at ¶42.13.

Note: The actual write-off period of depreciation for an asset is one year longer than the class life because of the convention rules explained in the following sections.

Three-year property. This class includes property with a class life of four years or less, other than cars and light-duty trucks which are in the five-year class.

This class includes: special handling devices for the manufacture of food and beverages; special tools and devices for the manufacture of rubber products; special tools for the manufacture of finished plastic products, fabricated metal products, or motor vehicles; and breeding hogs. By law, racehorses more than two years old when placed in service and other horses more than 12 years old when placed in service are also in the three-year class.

Five-year class. This class includes property with a class life of more than four years and less than 10 years such as computers (¶42.10), typewriters, copiers, duplicating equipment, heavy general-purpose trucks, trailers, cargo containers, and trailer-mounted containers. Also included by law in the five-year class are cars, light-duty trucks (actual unloaded weight less than 13,000 pounds), computer-based telephone central office switching equipment, computer-related peripheral equipment, semi-conductor manufacturing equipment, and property used in research and experimentation.

Seven-year class. This class includes any property with a class life of 10 years or more but less than 16 years. This is also a catch-all category for assets with no class life that have not been assigned by law to another class. Included in the seven-year class are: office furniture and fixtures, such as desks and files; cellular phones; fax machines; refrigerators; dishwashers; and machines used to produce jewelry, musical instruments, toys, and sporting goods. Single-purpose agricultural or horticultural structures placed in service in 1987 or 1988 are in the seven-year class; they are in the 10-year class if placed in service after 1988.

Ten-year property. This includes property with a class life of 16 years or more and less than 20 years, such as vessels and water transportation equipment, and assets used in petroleum refining or in the manufacture of tobacco products and certain food products.

The 10-year class includes single-purpose agricultural and horticultural structures, and trees or vines bearing fruit or nuts, if placed in service after 1988. Under a transition rule, the seven-year period will apply to single purpose agricultural or horticultural structures under construction on July 14, 1988, or acquired pursuant to a written contract binding on that date.

Fifteen-year property. This includes land improvements such as fences, shrubbery, roads and bridges. It also includes other property with a class life of 20 years or more but less than 25 years, such as municipal sewage plants and telephone distribution plants. A new law adds gas station convenience stores to the 15-year class for property placed in service on or after August 20, 1996.

Twenty-year property. This class includes property with a class life of 25 years or more, such as farm buildings and municipal sewers, except that residential and nonresidential real estate is excluded; *see* ¶42.13.

¶42.5 MACRS Rates

The MACRS rate depends on the recovery period (¶42.4) for the property and whether the half-year or mid-quarter convention applies. The 200% declining rate for three-year property is 66.67%; for five-year property, 40%; and for seven-year property it is 28.57%. *See* ¶42.8 for the 150% rate election. These rates are adjusted for the convention rules explained below. When the double declining rate provides a lower annual deduction than the straight-line rate, the double declining rate is replaced by the straight-line rate. The rates in the tables at the end of this section reflect the applicable convention and the change to a straight-line recovery.

Conventions. Under the half-year convention, all property acquired during the year, regardless of when acquired during the year, is treated as acquired in the middle of the year. As a result, only one-half of the full first-year depreciation is deductible and in the year after the last class life year, the balance of the depreciation is written off. Furthermore, in the year property is sold, only half of the full depreciation for that year is deductible; *see* ¶42.6.

The half-year convention applies unless the total cost bases of depreciable assets placed in service during the last three months of the taxable year exceed 40% of the total bases of all property placed in service during the entire year. If this 40% test applies, you must use a mid-quarter convention to figure your annual depreciation deduction, as explained at ¶42.7.

Buildings are depreciated using a mid-month convention; *see* ¶42.13.

Depreciation tables. The following table provides year-by-year rates for property in the three-, five-, and seven-years class. The rates incorporate the adjustment for the half-year or mid-quarter convention and the switch from the 200% declining rate to the straight-line method. Use the rate shown in the table under the convention for your asset. The rate is applied to original basis, minus any first-year expensing deduction; *see* ¶42.3. You claim the deduction from the table in the section of Form 4562 labeled "General Depreciation System" (GDS).

You use the tables for the entire recovery period unless you claim a deductible casualty loss that reduces your basis in the property. For the year of the casualty loss and later years, depreciation must be based on the adjusted basis of the property at the end of the year. The tables may no longer be used; *see* IRS Publication 946 for further details.

MACRS DEPRECIATION RATES

		Mid-Quarter Convention			
Year	*Half-Year Convention*	*1st*	*2nd*	*3rd*	*4th (Quarter)*
3-Year Property					
1	33.33%	58.33%	41.67%	25.00%	8.33%
2	44.45	27.78	38.89	50.00	61.11
3	14.81	12.35	14.14	16.67	20.37
4	7.41	1.54	5.30	8.33	10.19
5-Year Property					
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58
7-Year Property					
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73
8	4.46	1.09	3.33	5.53	7.64

EXAMPLE

During June 1996, you place in service a machine costing $20,000. It is your only acquisition in 1996. The machine is in the five-year class and subject to the half-year convention. The depreciation rate for the first year is 20% (*see* the above table of MACRS rates). Your 1996 depreciation deduction is $4,000 ($20,000 × 20%).

Summary of Deductions—

Year	*Deduction*
1	$4,000
2	6,400
3	3,840
4	2,304
5	2,304
6	1,152
Total	$20,000

¶42.6 Half-Year Convention for MACRS

The half-year convention treats all business equipment placed in service during a tax year as placed in service in the midpoint of that tax year. The same rule applies in the year in which the property is disposed of. The effect of this rule is as follows: A half-year of depreciation is allowed in the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, a full year of depreciation is claimed. If you hold the property for the entire recovery period, a half-year of depreciation is claimed for the year following the end of the recovery period. If you dispose of the property before the end of the recovery period, a half-year of depreciation is allowable for the year of disposition.

See the Table of MACRS Depreciation Rates in ¶42.5 for year-by-year rates under the half-year convention. Apply the rate from the table to the original basis, minus any first-year expensing (¶42.3) deduction claimed.

The Example in ¶42.5 shows the year-by-year deduction computation for five-year property under the half-year convention. If you dispose of the property before the end of the recovery period shown in ¶42.5, your deduction for the year of disposition is one-half of the deduction that would be allowed for the full year using the rate shown in the table.

¶42.7 Last Quarter Placements—Mid-Quarter Convention

A mid-quarter convention applies if the total cost bases of business equipment placed in service during the last three months of the tax year exceed 40% of the total bases of all the property placed in service during the year. You must use a mid-quarter convention for all property (other than nonresidential real property and residential

rental property) placed in service during the year. In applying the 40% rule, you do not count residential rental property, nonresidential realty, and assets that were placed in service and disposed of during the same year.

Under the mid-quarter convention, the first-year depreciation allowance is based on the number of quarters that the asset was in service. Property placed in service at any time during a quarter is treated as having been placed in service in the middle of the quarter. The mid-quarter convention also applies to sales and disposals of property. The disposal is treated as occurring in the midpoint of the quarter.

To figure your MACRS deduction for property subject to the mid-quarter convention, use the rate shown in the table in ¶42.5 for the quarter of the tax year the property is placed in service. In using the table, multiply the original basis, minus any first-year expensing deduction, by the applicable rate.

EXAMPLE

During August 1996, you place in service office furniture costing $1,000, and in October, a computer costing $5,000. You are on the calendar year. The total basis of all property placed in service in 1996 is $6,000. As the basis of the computer of $5,000 placed in service in the last quarter exceeds 40% of the total basis of all property placed in service during 1996, you must use the mid-quarter convention for the furniture and the computer. The office furniture, which is seven-year property, and the computer, which is five-year property, are depreciated using MACRS and a mid-quarter convention.

You first multiply the $1,000 basis of the furniture by 10.71%—the seven-year property mid-quarter convention rate for the third quarter (*see* table in ¶42.5). The depreciation deduction is $107. You then multiply the $5,000 basis of the computer by 5%—the five-year property mid-quarter convention rate for the fourth quarter (*see* table in ¶42.5). The deduction is $250. Total depreciation is $357.

¶42.8 150% Rate Election

Instead of using the 200% rate for property in the three-, five-, seven-, and 10-year classes, you may elect a 150% rate. You may prefer the 150% rate when you are subject to the alternative minimum tax (AMT). For AMT purposes, you must use the 150% rate and adjust your taxable income if the 200% rate was used for regular tax purposes; *see* ¶23.5. To avoid this double accounting, you may elect to apply the 150% rate for regular tax purposes. The 150% rate is applied over the alternative straight-line recovery period; *see* ¶42.9. Thus, the recovery period is five years for cars and computers and 10 years for furniture and fixtures. If a half-year convention applies, the first-year rate for the five-year class is 15%, and 7.50% for the 10-year class; *see* the table below. If you are subject to the mid-quarter convention, *see* IRS Publication 946 for the tables showing mid-quarter convention rates.

The election to use the 150% rate must be made for all property within a given class placed in service in the same year. The election is irrevocable.

Apply the rate from the table to your original basis, minus any first-year expensing deduction claimed.

Half-Year Convention—150% rate

	Property Class	
Year—	*5-Year—*	*10-Year—*
1	15.00%	7.50%
2	25.50	13.88
3	17.85	11.79
4	16.66	10.02
5	16.66	8.74
6	8.33	8.74
7		8.74
8		8.74
9		8.74
10		8.74
11		4.37

¶42.9 Straight-Line Depreciation

You may not want an accelerated rate and may prefer to write off depreciation at an even pace. There are two straight-line methods. You may make an irrevocable election to use the straight-line method over the regular MACRS recovery period (¶42.4) under the general depreciation system (GDS), or you may elect straight-line recovery over the designated recovery period for the class life under the alternative depreciation system (ADS). For some assets, such as cars, the GDS and ADS recovery periods are the same (five years for a car).

Half-year and quarter-year conventions apply to both straight-line methods; *see* ¶42.6 and ¶42.7. A mid-month convention applies under the straight-line rule for buildings; *see* ¶42.13.

Straight-line over regular recovery period (GDS). You make this election in the section of Form 4562 labeled “General Depreciation System” (GDS). To elect this method for one asset, you must also use it for all other assets in the same class that are placed in service during the year. The straight-line election is irrevocable.

Straight-line under the alternative depreciation system (ADS). Under the alternative depreciation system (ADS), the straight-line recovery period for cars, light trucks, and computers is five years, the same as under the regular MACRS method. For business furniture and fixtures, the ADS straight-line recovery period is 10 years, but, as discussed above, you may instead elect to use straight-line recovery over the regular seven-year MACRS recovery

period (GDS). The ADS recovery period for personal property with no class life is 12 years. For nonresidential real and residential rental property, you may elect ADS straight-line recovery over 40 years. *See* IRS Publication 946 for other ADS class lives.

Except for real estate, the ADS election applies to all property within the same class placed in service during the taxable year. For real estate, the election to use the alternative depreciation method may be made on a property-by-property basis. The election is irrevocable.

The deduction is claimed in the section of Form 4562 labeled "Alternative Depreciation System" (ADS).

Should you elect straight-line recovery? Accelerated rates of MACRS merely give you an opportunity to advance the time of taking your deduction. This may be a decided advantage where the higher deductions in the first few years will provide you with cash for working capital or for investments in other income-producing sources. That is, by accelerating the deductions, you defer the payment of taxes that would be due if you claimed smaller depreciation deductions, using more conservative straight-line rates. The tax deferral lasts until the rapid method provides less depreciation deductions than would the more conservative method. Your ability to receive the benefits of MACRS generally is more feasible in an ongoing business.

If you are starting a new business in which you expect losses or low income at the start, accelerated MACRS may waste depreciation deductions that could be used in later years when your income increases. Therefore, before deciding to use the faster write-offs of MACRS, consider your income prospects.

Straight-line rate table. The table in the next column shows straight-line rates for five-year, seven-year, and 10-year property under the half-year convention. As discussed earlier, the recovery period depends on whether the GDS or ADS straight-line method is used. If you are subject to the mid-quarter convention (¶42.7), *see* IRS Publication 946 for tables showing the applicable rates.

Half-Year Convention—Straight-Line Rate

		Property Class	
Year—	*5-Year—*	*7-Year—*	*10-Year—*
1	10.00%	7.14%	5.00%
2	20.00	14.29	10.00
3	20.00	14.29	10.00
4	20.00	14.28	10.00
5	20.00	14.29	10.00
6	10.00	14.28	10.00
7		14.29	10.00
8		7.14	10.00
9			10.00
10			10.00
11			5.00

AMT depreciation. For alternative minimum tax (AMT) purposes, depreciation is figured using the 150% declining rate if double declining MACRS rates were used for regular tax purposes; *see* ¶23.5. If straight-line depreciation was used for regular tax purposes, AMT depreciation is figured using the straight-line alternative depreciation system (ADS) over the class life recovery period. For real estate placed in service after 1986, AMT depreciation is figured using the 40-year ADS straight-line method.

Mandatory straight-line depreciation. You are required to use the alternative depreciation system for automobiles (¶43.3) and certain computers (¶42.10) used 50% or less for business.

Alternative MACRS depreciation must also be used for:

- Figuring earnings and profits;
- Tangible property which, during the taxable year, is used predominantly outside the United States;
- Tax-exempt use property;
- Tax-exempt bond financed property; and
- Imported property covered by an executive order.

¶42.10 Computers and Other Listed Property

"Listed property" is a term applied to certain equipment that may be used for personal and business purposes. For such property, the law allows first-year expensing (¶42.3) or accelerated MACRS (¶42.5) deductions only if business use exceeds 50%. For business use of 50% or less, you must use ADS straight-line depreciation; *see* ¶42.9. Deductions for listed property are claimed on Form 4562. If the more-than-50% business-use test is met in the first year and first-year expensing or accelerated MACRS is claimed, but business use of listed property falls to 50% or less during the ADS straight-line recovery period (¶42.9), you must "recapture" first-year expensing and accelerated MACRS deductions; *see* Example 2 on the next page.

What is "listed property"? Listed property includes passenger autos weighing 6,000 pounds or less, trucks (*see* ¶43.3 for exceptions), cellular phones, computers and peripheral equipment, boats, airplanes, and any photographic, sound, or video recording equipment that could be used for entertainment or recreational purposes. However, exceptions remove some items from the listed property class for many businesses. Listed property does not include (1) any computer or peripheral equipment used exclusively at a regular business establishment owned or leased by you, and (2) photographic, phonographic, communications, or video equipment used exclusively and regularly in your business or regular business establishment. A home office that meets the rules of ¶40.11 is considered a business establishment.

EXAMPLES

1. You buy a computer in 1996 and use it exclusively in your regular business office. The computer is not listed property. You may claim either first-year expensing (¶42.3) or accelerated MACRS depreciation (¶42.5) for your investment on Form 4562. If business use falls to 50% or less after 1996, the only deduction subject to recapture is the first-year deduction; *see* ¶42.3.
2. You have no regular business establishment and use a computer bought in 1996 as a free-lance consultant. The computer is listed property and you may claim MACRS and/or first-year expensing only if you use the computer more than 50% for business. If business use does not exceed 50%, you may only claim ADS straight-line depreciation (¶42.9). Your deductions are claimed in the section for "Listed Property" on Form 4562.

If business use exceeds 50% in the first year but in a later year drops to 50% or less, MACRS and any first-year depreciation are subject to "recapture." In the year in which business use drops to 50% or less, you recapture the excess of (1) the MACRS and first-year expensing deductions claimed in prior years over (2) the deduction that would have been allowed using the straight-line alternative depreciation rates of ¶42.9. For the rest of the recovery period, you continue to use the alternative straight-line rate.

Recapture is figured on Form 4797. The recapture computation follows the steps shown in ¶43.9 for recapture of excess depreciation on an automobile.

Investor's use of computer. For an investor who uses a home computer for managing an investment portfolio, the computer is treated as listed property. Unless the computer is also used for business, and the computer time spent on business work exceeds 50% of the total, only straight-line depreciation may be claimed; neither first-year expensing nor accelerated MACRS is allowed. Although the investment use is disregarded for purposes of the more-than-50% business-use test, the investment use is combined with the business use for purposes of determining the percentage of depreciable cost. Depreciable investment use must relate to managing investments that produce taxable income. *See* the Examples below.

EXAMPLES

1. In 1996, Jane Adams buys a computer; she uses it 50% of the time to manage her stock investments and 40% in a part-time research business. The more-than-50% business-use test is not met for claiming first-year expensing or accelerated MACRS deductions. She must use ADS straight-line depreciation over five years (¶42.9); her depreciable basis is 90% of cost.
2. Assume that Jane used the computer 60% of the time for business and 30% for investment. As business use exceeds 50%, she may claim first-year expensing under the rules of ¶42.3. If she instead claims accelerated MACRS, the MACRS rate is applied to 90% of her cost.

Leasing a computer or cellular phone. You may deduct the portion of your lease payments attributable to business use. However, if business use is 50% or less for any year, you must report as income an amount based on the fair market value of the unit, the percentage of business plus investment use, and percentages from two IRS tables shown in Publication 534.

Computer software. Software purchased "off the shelf" and used for business or investment purposes is depreciable over a three-year period provided it has a useful life exceeding one year. If the useful life does not exceed one year, the cost is immediately deductible. Also *see* ¶42.19.

¶42.11 ACRS Recovery for Assets in Service Before 1987

Assets other than real estate placed in service after 1980 and before 1987 fell within one of the following ACRS classes: three-, five-, or 10-year property.

Three-year property. This class included automobiles, taxis, light-duty trucks (actual unloaded weight of less than 13,000 pounds), equipment used for research and experimentation, hogs used for breeding, racehorses more than two years old, and any other horse more than 12 years old when placed in service.

With the exception of certain automobiles (¶43.6), three-year property is no longer depreciable unless a straight-line recovery over 12 years was elected; *see* ¶42.12.

Five-year property. All tangible personal property had a five-year recovery period, unless specifically included in the three-year or 10-year class. Thus, most equipment and other business assets qualified for a five-year write-off, including office furniture, typewriters, computers, calculators, copiers, and single-purpose agricultural structures. Facilities used for storage of petroleum and its primary products also fell within the five-year class.

Five-year property is no longer depreciable unless you elected straight-line recovery over a period of 12 years or 25 years; *see* ¶42.12.

Ten-year property. This is a limited category covering assets in residential mobile homes, theme and amusement parks, railroad tank cars, public utility equipment with an ADR class life of more than 18 but not more than 25 years (except research and experimentation equipment included in the three-year class), and public utility equipment used in coal conversions. If a straight-line recovery over 10, 25, or 35 years was elected, *see* ¶42.12.

Dispositions. No depreciation deduction is allowed in the year you dispose of three-year, five-year, or 10-year ACRS property.

Real estate. *See* ¶42.16 for ACRS rates.

Pre-ACRS assets. For assets placed in service before 1981, the straight-line and declining balance methods are discussed in IRS Publication 534.

Residential Rental Property (27.5 Years)

Use the column for the month of taxable year placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2–9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636

Nonresidential Real Property (31.5 years—placed in service before May 13, 1993)

Use the column for the month of taxable year placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2–7	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
11	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174

Nonresidential Real Property (39 years—placed in service on or after May 13, 1993)

Use the column for the month of taxable year placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564

¶42.12 Straight-Line Recovery for Equipment in Service Before 1987

You may still be able to claim straight-line deductions for three-year ACRS property if you elected a recovery period of 12 years, or for five-year property if a recovery period of 12 or 25 years was elected. For 10-year property, an election could have been made to elect straight-line depreciation over 10, 25, or 35 years.

If you made the straight-line election, the straight-line rate to be used on your 1996 return is as follows:

Recovery Period—	*Rate—*
10 years	10.000%
12 years	8.333%
25 years	4.000%
35 years	2.857%

Because of the half-year convention, only 50% of the above percentages was allowed in the year the property was placed in service. If the property is held for the entire elected recovery period, another half-year of depreciation is allowed for the year following the end of the recovery period. If property is disposed of prior to the end of the recovery period, no cost recovery is allowable in the year of disposition.

¶42.13 MACRS for Real Estate Placed in Service After 1986

The recovery period for residential rental property placed in service after December 31, 1986, is 27.5 years. The recovery period for nonresidential real property depends on when the property was placed in service.

The method of recovery for nonresidential or residential property is the straight-line method using a mid-month convention. *See* page 556 for rate tables for each class of property.

For nonresidential real property placed in service after December 31, 1986, but before May 13, 1993, the depreciation recovery period is 31.5 years.

For nonresidential real property placed in service after May 12, 1993, the recovery period is 39 years. Under a transition rule, the 31.5-year recovery period rather than the 39-year recovery period applies to a building placed in service before 1994 if before May 13, 1993, you had entered into a binding, written contract to buy or build it, or if, before that date, you had begun construction. The transition rule also applies if you obtained the contract or property from someone else who satisfied the pre-May 13, 1993, contract or construction requirement, provided he or she never put the building in service and you did so before 1994.

Residential rental property is a rental building or structure for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building, the gross rental income includes the fair rental value of the part you occupy.

A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure, but not a unit in a hotel, motel, inn, or other establishment where more than one-half of the units are used on a transient basis.

Mid-month convention. Under a mid-month convention, all property placed in service or disposed of during any month is treated as placed in service or disposed of on the midpoint of that month. You may determine the first-year deduction for residential rental property by applying the percentage from the table on the next page to the original depreciable basis. In later years, use the same column of the table to figure your deduction.

EXAMPLE

In February 1996, you buy and place in service an apartment building for $100,000. You use the calendar year. The table on the previous page gives a first-year depreciation rate of 3.182% for 27.5- year residential rental property placed in service during February. Applying this rate, you get a deduction of $3,182.

For 1997, the rate will be 3.636%, for a deduction of $3,636.

Additions or improvements to property. The depreciation deduction for any additions to, or improvement of, any property is figured in the same way as the deduction for the property would be figured if the property had been placed in service at the same time as the addition or improvement.

The MACRS class for the addition or improvement is determined by the MACRS class of the property to which the addition or improvement is made. The period for figuring depreciation begins on the date that the addition or improvement is placed in service, or, if later, the date that the property to which the addition or improvement was made is placed in service.

¶42.14 Demolishing a Building

When you buy improved property, the purchase price is allocated between the land and the building; only the building may be depreciated. The land may not; *see* ¶42.2. If you later demolish the building, you may not deduct the cost of the demolition or the undepreciated basis of the building as a loss in the year of demolition. Expenses or losses in connection with the demolition of any structure, including certified historic structures, are not deductible. They must be capitalized and added to the basis of the land on which the structure is located.

Major rehabilitation. Where you are considering a major rehabilitation of a building which involves some demolition of the building, IRS guidelines may allow you to deduct the costs of demolition and a removal of part of the structure. Under the IRS rules, the costs of structural modification do not have to be capitalized if 75% or more of the existing external walls are retained as internal or external walls and 75% or more of the existing internal framework is also retained. For certified historic structures, the modification must also be part of a certified rehabilitation. The 75% tests are effective for work starting after June 5, 1995, and also for open taxable years, if an election is made for those years.

¶42.15 Leasehold Improvements

Lessee improvements. Leasehold improvements placed in service after 1986 by a lessee are depreciated under MACRS real estate rates listed at ¶42.13. You ignore the term of the lease. If the lease term is shorter than the MACRS life and you do not retain the improvements at the end of the term, the remaining undepreciated basis is considered in computing gain or loss at that time.

Pre-1987 improvements. For leasehold improvements placed in service before 1987, the cost of improvements is deductible over the *shorter* of the following periods:

1. The useful life of the improvement if the improvement was before 1981, or the ACRS recovery period if after 1980 but before 1987, *and*
2. The remaining term of the lease.

If (1) is the shorter period, the cost of the improvement is depreciated. If (2) is the shorter period, the cost is amortized ratably.

In determining the shorter period, you must add optional lease renewals to the remaining lease term under (2) if, at the completion of the improvement, the remaining term of the original lease (excluding unexercised renewal options) is less than 60% of the useful life (or ACRS recovery period) of the improvement. Renewals do not have to be taken into account under the 60% test if the lessee can show that it is more probable that the lease would not be renewed than that it would be renewed.

If the lessee and lessor are related, the term of the lease is treated as being equal to the remaining useful life (or recovery period) of the improvement. Related parties include spouses, children, grandchildren, parents, grandparents, brothers, sisters, and certain controlled corporations, partnerships, and trusts.

Abandonment of leasehold improvements. Upon the termination of a lease, the adjusted basis of a lessee's leasehold improvements that are abandoned may be included by the lessee to compute gain or loss. The treatment of improvements made by a lessor upon termination of a lease has been disputed. The IRS has held that leasehold improvements made by a lessor that are considered structural components of a building must be continued to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term.

A new law provides a more favorable rule for dispositions after June 12, 1996, and allows a lessor to follow the rule applied to lessees if the improvements are irrevocably disposed of or abandoned. The lessor may recognize loss for the remaining adjusted basis of the improvements.

¶42.16 Depreciating Real Estate Placed in Service After 1980 and Before 1987

The ACRS recovery period of a building that does not qualify as low-income housing depends on the year in which the building was placed in service:

- For buildings placed in service after May 8, 1985, and before 1987, the recovery period is 19 years.
- For buildings placed in service after March 15, 1984, and before May 9, 1985, the recovery period is 18 years.
- For buildings placed in service before March 16, 1984, and for all low-income housing, the recovery period is 15 years.

Mobile homes and theme parks are in a 10-year class and agricultural, horticultural, and petroleum storage structures are in the five-year class.

Under transitional rules, some 19-year buildings may be depreciated over 18 years, and some 18-year buildings over 15 years if placed in service before 1987. Specifically, recovery over 18 years is allowed for a building placed in service after May 8, 1985, provided that before May 9, 1985, (1) you began construction or had a binding contract to buy the building, and (2) you placed the building in service before the end of 1986. The 18-year period also applies if construction was begun, or a contract entered into by a person who transferred the rights to you and you placed the building in service before 1987. Recovery over 15 years is allowed for a building that you (or a prior owner who transferred the right to you) began constructing or contracted for before March 16, 1984, provided you placed it in service before the end of 1986.

Election to use straight-line depreciation. You may have elected to use the straight-line method over the regular recovery period: 19 years for 19-year property, 18 years for 18-year property, and 15 years for 15-year property. Furthermore, for any building, a longer recovery period of either 35 or 45 years was available. An election of the straight-line method for real property had to be made on a property-by-property basis, by the return due date, plus extensions, for the year the property was placed in service.

Rate of recovery. The rate of recovery is listed in Treasury tables which are available in IRS Publication 534. The specific rates are adjusted according to the month in the first year in which a building or improvement is placed in service.

Substantial improvements. Substantial improvements made after 1986 to an ACRS building are depreciable under MACRS (¶42.13), not ACRS.

Dispositions. If you dispose of 15-year real property, the ACRS deduction for the year of disposition is based on the number of full months in use. However, no deduction is allowed for the month of disposition.

The same full-month convention rule applies to dispositions of 18-year property placed in service before June 23, 1984.

If you dispose of other 18-year or 19-year real property, the ACRS deduction for the year of disposition is based on the number of months in use determined under a mid-month convention. Under the mid-month convention, real property disposed of any time during a month is treated as disposed of in the middle of that month. You count the month of disposition as one-half of a month of use.

See ¶44.1 for recapture rules on the sale of ACRS property.

¶42.17 When MACRS Is Not Allowed

If you place in service personal property which you previously used or which was previously owned by a related taxpayer before 1987, you may not be able to apply MACRS rules. This anti-churning restriction is designed to discourage asset transfers between related persons to take advantage of MACRS deductions that exceed the deductions allowed before 1987 under ACRS. The anti-churning restriction does not apply to personal property if, for the first full taxable year of service, the deduction allowable under ACRS would be greater than the deduction allowable under MACRS.

The anti-churning rule also does not bar MACRS rules for real estate acquired after 1986, unless you lease back the real estate to a related party who owned it before 1987.

Special rules also apply to the transfer of property in certain tax-free corporate or partnership transactions where the property was used before 1987. If you receive property in a tax-free exchange, you may have to use the method used by the transferor in computing the ACRS deduction for that part of basis that does not exceed what was the transferor's basis in the property. To the extent that basis exceeds the transferor's, the MACRS rules may apply; for example, when you paid boot in addition to transferring property.

Where property is disposed of and reacquired, the depreciation deduction is computed as if the disposition had not occurred.

¶42.18 Amortizing Goodwill and Other Intangibles (Section 197)

The costs of intangibles coming within Section 197 are amortized over a 15-year period. The 15-year period applies regardless of the actual useful life of "Section 197 intangibles" acquired after August 10, 1993, and held in connection with a business or income-producing activity.

Generally, the amount subject to amortization is cost. Annual amortization is reported on Form 4562. The 15-year period starts with the month the intangible was acquired.

A "Section 197 intangible" is: (1) goodwill; (2) going-concern value; (3) workforce in place; (4) information base; (5) know-how, but *see* exceptions below; (6) any customer-based intangible; (7) any supplier-based intangible; (8) any license, permit, or other right granted by a governmental unit or agency; (9) any covenant not to compete made in the acquisition of a business; and (10) any franchise, trademark, or trade name.

Goodwill. Goodwill is the value of a business attributable to the expectancy of continued customer patronage, due to the name or reputation of a business or any other factor.

Covenants not to compete. A covenant not to compete is a Section 197 intangible if paid for in connection with the acquisition of a business. Excessive compensation or rental paid to a former owner of a business for continuing to perform services or provide the use of property is considered an amount paid for a covenant not to compete if the services or property benefits the trade or business. But an amount paid under a covenant not to compete which actually represents additional consideration for corporate stock is not a Section 197 intangible and must be added to the basis of the acquired stock.

Franchises, trademarks, and trade names. A franchise (excluding sports franchises), trademark, or trade name is a Section 197 intangible. Amounts, whether fixed or contingent, paid on the transfer of a trademark, trade name, or franchise are chargeable to capital account and must be ratably amortized over a 15-year period. The renewal of a franchise, trademark, or trade name is treated as an acquisition of the franchise, trademark, or trade name. Renewal costs are amortized over 15 years beginning in the month of renewal.

Know-how. A patent, copyright, formula, process, design, pattern, format, or similar item may be a Section 197 intangible. However, the following interests are not Section 197 intangibles unless acquired as part of the acquisition of a business: patents, copyrights, and interests in films, sound recordings, videotapes, books, or other similar property.

Customer-based intangibles. Customer-based intangibles include the portion of an acquired trade or business attributable to a customer base, circulation base, undeveloped market or market growth, insurance in force, investment management contracts, or other relationships with customers that involve the future provision of goods or services.

Supplier-based intangibles. The portion of the purchase price of an acquired business attributable to a favorable relationship with persons who provide distribution services, such as favorable shelf or display space at a retail outlet, the existence of a favorable credit rating, or the existence of favorable supply contracts, are Section 197 intangibles.

Going-concern value. This is the additional value that attaches to property because it is an integral part of a going concern. This includes the value attributable to the ability of a trade or business to continue to operate and generate sales without interruption in spite of a change in ownership.

Workforce in place. The portion of the purchase price of an acquired business attributable to a highly skilled workforce is amortizable over 15 years. Similarly, the cost of acquiring an existing employment contract is amortizable over 15 years.

Information base. This includes the cost of acquiring customer lists; subscription lists; insurance expirations; patient or client files; lists of newspaper, magazine, radio, or television advertisers; business books and records; and operating systems. The intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems is also a Section 197 intangible.

Self-created intangibles. A Section 197 intangible created by a taxpayer is generally not amortizable, unless created in connection with a transaction that involves the acquisition of assets of a business. However, this deduction bar for self-created intangibles does not apply to the following: (1) any license, permit, or other right granted by a governmental unit or agency; (2) a covenant not to compete entered into on the acquisition of a business; or (3) any franchise, trademark, or trade name. For example, the 15-year amortization period may apply to the capitalized costs of registering or developing a trademark or trade name.

A person who contracts for or renews a contract for the use of a Section 197 intangible may not be considered to have created that intangible. For example, a licensee who contracts for the use of know-how may amortize capitalized costs over 15 years.

The following intangible assets are not Section 197 intangibles: (1) interests in a corporation, partnership, trust, or estate; (2) interests under certain financial contracts; (3) interests in land; (4) certain computer software; (5) certain separately acquired rights and interests; (6) interests under existing leases of tangible property; (7) interests under existing indebtedness; (8) sports franchises; (9) certain residential mortgage servicing rights; and (10) certain corporate transaction costs.

Computer software. Computer software is *not* a Section 197 intangible if it: (1) is readily available to the general public; (2) is not subject to an exclusive license; and (3) has not been substantially changed. Furthermore, even computer software falling outside of this exception is considered a Section 197 intangible only if acquired in the acquisition of a business. For software excluded from Section 197 treatment, *see* ¶42.19.

Loss limitations. A person who disposes of an amortizable Section 197 intangible at loss and at the same time retains other Section 197 intangibles acquired in the same transaction may not deduct the loss. The disallowed loss is added to the basis of the retained Section 197 intangibles. The same rule applies if a Section 197 intangible is abandoned or becomes worthless and other Section 197 intangibles acquired in the same transaction are kept. The basis of the remaining intangibles is increased by the disallowed loss.

You may not treat a covenant not to compete as worthless any earlier than the disposition or worthlessness of the entire interest in a business.

Anti-churning rule. No deduction is allowed for goodwill, going-concern value, or any other Section 197 intangibles acquired by a taxpayer after August 10, 1993, if:

1. The taxpayer or a related person held or used the intangible at any time on or after July 25, 1991, and on or before August 10, 1993;
2. The taxpayer acquired the intangible from a person who held it at any time on or after July 25, 1991, and on or before August 10, 1993, and, as part of the transaction, the user of the intangible does not change; or
3. The taxpayer grants the right to use the intangible to a person or a related person who held or used the intangible at any time on or after July 25, 1991, and on or before August 10, 1993.

Who are related persons? A person may be treated as related to another person if engaged in businesses under common control. A 20% ownership test is used to determine the stock and partnership percentages.

An exception to the "anti-churning" rule may apply if the person from whom the intangible is acquired elects to recognize gain on its disposition and pay a tax on the gain which, when added to other income taxes imposed on the gain, equals the product of the gain and the highest rate of income tax applicable to the person. If the election is made, the anti-churning rules apply to the intangible only to the extent that adjusted basis in the intangible exceeds the recognized gain.

The anti-churning rules do not apply to a Section 197 intangible acquired from a decedent if the basis of the intangible is stepped up to fair market value.

Dispositions. An amortizable Section 197 intangible is not a capital asset. It is treated as depreciable property, and if held for more than one year, it will generally qualify as a Section 1231 asset; *see* ¶44.1. Amortization claimed on a Section 197 intangible is subject to recapture under Section 1245 and gain on its sale to certain related persons is subject to ordinary income treatment under Section 1239.

¶42.19 Deducting the Cost of Computer Software

The cost of software installed in a computer that you buy and use in your business is not deducted separately, unless the software cost is separately stated. In most cases, the cost of software bundled with a computer is not separately stated. The cost of the computer including such software is depreciable under the rules of ¶42.10.

If you buy software for business use, such as a database or spreadsheet program, the treatment of the cost depends on your use of the program. If you use it for a year or less, such as an annual tax program, you may deduct the cost as a business expense for that year. If the useful life in your business exceeds a year, you may depreciate the cost over 36 months.

See ¶42.18 for 15-year amortization of certain software acquired in the acquisition of a business.